FILE COPY

Supreme Court of the United States

OCTOBER TERM, 1944.

No. 137.

PRUDENCE REALIZATION CORPORATION,
Petitioner,

—v.—

JOSEPH W. FERRIS, GEORGE L. LONG and HENRY LEIFERT as Trustees under a Declaration of Trust dated as of July 1st, 1938, with respect to 307 West 36th Street (Burnside) First Mortgage Participation Certificates, CITY BANK FARMERS TRUST COMPANY and MARTIN S. LINDGROVE as Trustees under the Last Will and Testament of HERMAN STUTZER, deceased, on behalf of themselves and other holders of certificates in 307 West 36th Street (Burnside) First Mortgage Participation Certificates, SOLOMON ZAUDERER, MILTON KIMMELMAN, IRVING ZAUDERER and CHARLES KIMMELMAN, doing business as KIMMELMAN AND ZAUDERER, on behalf of themselves and all other holders of Prudence Bonds Corporation participating certificate issue, and HUNTER L. DELATOUR, RAYMOND REISLER and JEROME THRALLS, Trustees of REALTY ASSOCIATES SECURITIES CORPORATION, debtor, holders of Burnside Certificates,

Respondents.

BRIEF ON BEHALF OF RESPONDENTS CITY BANK FARMERS TRUST COMPANY AND MARTIN S. LINDGROVE, AS TRUSTEES, ETC., IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF NEW YORK, COUNTY OF NEW YORK.

JOHN ROSS DELAFIELD,
ROBERT MCC. MARSH,
EUGENE BLANC, JR.,
Counsel for City Bank Farmers
Trust Company and Martin S. Lindgrove,
as Trustees, etc., Respondents.

SUBJECT INDEX.

	PAGE
Table of Cases and Statutes Cited	1
Opinions Below	2
Statement of the Case	2
Summary of Argument	10
Argument	11
Point I	11
II	14
III	17
IV	22
V	24

TABLE OF CASES AND STATUTES CITED.

	PAGE
Erie R. R. Co. v. Tompkins, 304 U. S. 64	15
Ferris v. Prudence Realization Corporation, 292 N. Y. 210	12, 15, 16, 18, 22
Fort Dodge Hotel Co. v. Bartelt, 119 F. 2d 253	16
Francis v. Humphrey, 25 F. Supp. 1	16
Geist v. Prudence Realization Corporation, 122 F. 2d 503	16
Ivanhoe Building & Loan Association v. Orr, 295 U. S. 243	3
Madden v. Metropolitan Life Insurance Co., 138 F. 2d 708	15
Meredith v. Winter Haven, 320 U. S. 228	15
Palmer v. Hoffman, 318 U. S. 109	16
Prudence Realization Corporation v. Geist, 316 U. S. 89	14, 15, 16, 17, 18
Sampson v. Channell, 110 F. 2d 754	16
Thompson v. Magnolia Petroleum Co., 309 U. S. 478	13
In re The Westover, Inc., 82 F. 2d 177	2

Statutes Cited.

	PAGE
New York Insurance Law: Section 544 (6)	4
National Bankruptcy Act: Section 77-B	3, 5

Supreme Court of the United States

OCTOBER TERM, 1944.

No. 137.

PRUDENCE REALIZATION CORPORATION,
Petitioner,

—v.—

JOSEPH W. FERRIS, GEORGE L. LONG and HENRY LEIFERT as Trustees under a Declaration of Trust dated as of July 1st, 1938, with respect to 307 West 36th Street (Burnside) First Mortgage Participation Certificates, CITY BANK FARMERS TRUST COMPANY and MARTIN S. LINDGROVE as Trustees under the Last Will and Testament of HERMAN STUTZER, deceased, on behalf of themselves and other holders of certificates in 307 West 36th Street (Burnside) First Mortgage Participation Certificates, SOLOMON ZAUDERER, MILTON KIMMELMAN, IRVING ZAUDERER and CHARLES KIMMELMAN, doing business as KIMMELMAN AND ZAUDERER, on behalf of themselves and all other holders of Prudence Bonds Corporation participating certificate issue, and HUNTER L. DELATOUR, RAYMOND REISLER and JEROME THRALLS, Trustees of REALTY ASSOCIATES SECURITIES CORPORATION, debtor, holders of Burnside Certificates,
Respondents.

BRIEF ON BEHALF OF RESPONDENTS CITY BANK FARMERS TRUST COMPANY AND MARTIN S. LINDGROVE, AS TRUSTEES, ETC., IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF NEW YORK, COUNTY OF NEW YORK.

OPINIONS BELOW.

The opinion of the Supreme Court, New York County, Additional Special Term, appears at R. 322-323.

The opinion of the Appellate Division, First Department, appears at R. 340-343, and is reported in 266 App. Div. 543.

The opinion of the Court of Appeals of the State of New York appears at R. 359-375, and is reported in 292 N. Y. 240.

STATEMENT OF THE CASE.

On June 25th, 1927, The Prudence Company, Inc., the owner of a bond and mortgage in the principal sum of $1,200,000.00, made by Burnside Improvement Co., assigned them without consideration to a wholly controlled affiliate, Prudence-Bonds Corporation, pursuant to an arrangement whereby the latter was to issue certificates participating therein.

As a part of this arrangement, Prudence-Bonds Corporation assigned the bond and mortgage to The Bank of America as depositary, pursuant to a deposit agreement entered into between them at the same time (R. 28-47). The Prudence Company, Inc., then executed an instrument guaranteeing to the holders of the certificates to be issued the payment of interest thereon when due, and of the principal thereof when due or within eighteen months thereafter (Exhibit C, R. 53-58).

Certificates were thereafter issued and are outstanding in the hands of various persons, to the extent of $1,016,000.00. The holders of such certificates became tenants in common of the bond and mortgage (R. 19; Exhibit B, R. 48-53. *In re The Westover, Inc.*, 82 F. 2d 177; C. C. A. (2) 1936).

The mortgage and the certificates matured, by their terms, on July 1, 1932 (R. 213), but the mortgagor defaulted in the payment of an installment of principal due January, 1932. After such default, certificates aggregating $431,212.86

in principal amount were reacquired, as hereinafter stated, by The Prudence Company, Inc., the defaulting guarantor, and are now held by its successor, the petitioner Prudence Realization Corporation.

The first reorganization proceeding involved herein is that of The Prudence Company, Inc. (hereinafter called the "guarantor"). On March 4, 1933, the guarantor was taken over by the Superintendent of Banks of the State of New York. On February 1, 1935, it filed its petition in the United States District Court for the Eastern District of New York, asking for reorganization under Section 77-B of the Bankruptcy Act. The Court approved the petition on the same day, consolidated it with an involuntary proceeding against the guarantor theretofore commenced, appointed trustees, and later adjudicated the guarantor insolvent (R. 24). Thereafter a Plan for its reorganization was confirmed by the District Court (R. 64-102).

The effect of the Plan was to transfer to petitioner for liquidation all assets of the defaulting guarantor (R. 24-25), including the reacquired Burnside certificates. The holders of Prudence-guaranteed securities had filed claims against the guarantor, based on the default in the guaranty. In bankruptcy *simpliciter*, as distinguished from corporate reorganization in the Bankruptcy Court, such claims would have been unsecured claims allowable to the full extent thereof, *i.e.*, the face value of the certificates and interest thereon. See *Ivanhoe Building & Loan Association* v. *Orr*, 295 U. S. 243. The guarantor's Plan, however, changed this, treated the guaranty claims as secured by "Collateral," (R. 70-71), and reduced them by the "New Loan Value" of the mortgaged property underlying the certificates to which the guaranty attached (R. 73-74; 85). Claimants participated in the Plan only to the extent of the reduced amount. The "New Loan Value" of such property or "Collateral" was fixed by a formula in the Plan (R. 95-99).

Thus, distribution by the petitioner of amounts realized by it on the assets of the bankrupt guarantor was to be made in accordance with the agreement incorporated in the Plan,

rather than in accordance with the Bankruptcy Law. This agreement treated the guaranty holders as secured creditors (R. 84-88) and approximated the method adopted in the reorganization of mortgage and guarantee companies in the Courts of the State of New York. N. Y. Insurance Law, § 544 (6). Nothing in the Plan, or in the order confirming it, fixed or adjudicated the value or priority of lien of the assets transferred to petitioner.

The Plan recognized that the question of parity existed and that if the reacquired certificates were subordinated, their value as an asset would be less. The Plan accordingly provided that if there should be

> "uncertainty whether certificates of such issue held by the Debtor's estate on the Effective Date are on a parity with other certificates of such issue, the deduction to be made pursuant to the foregoing clause (1) shall be based in the first instance on the assumption that the certificates so held in the Debtor's estate are not entitled to parity, and an appropriate reserve shall be established by the New Company to provide for the additional distribution to be made to certificate holders of such issue if the Board of Directors shall be later satisfied that such parity exists; the Board of Directors being authorized to discontinue such reserve if and when satisfied that such parity does not exist; * * *" (R. 86).

"Debtor" in the above quotation means the guarantor; "New Company" means the present petitioner, Prudence Realization Corporation.

The Plan also recognized that certificate holders had dealt or would deal with their certificates and the underlying mortgages in separate reorganizations thereof. In order, to anticipate and prevent the argument that such dealings might constitute a waiver of claims, such as the claim to subordinate the guarantor's reacquired certificates, the certificate holders required the guarantor's plan to provide that unless a guarantee claim should have been expressly withdrawn, released, compromised or expunged,

> "no action taken subsequent to February 1, 1935, by or on behalf of any holder of a guarantee claim against the Debtor with respect to his Collateral shall bar any such claimant from participating in the benefits of the Plan to the extent herein provided" (R. 95).

"Collateral" means the mortgage underlying the certificates; February 1, 1935 is the date of the approval of the guarantor's petition for reorganization.

The District Court's order confirming the guarantor's Plan recognized the existence of equities in favor of third persons, and preserved such equities as follows (R. 119):

> "The Section 77-B Trustee of the Debtor is hereby further directed to transfer to the New Company forthwith, subject to all then existing equities and rights of third parties therein, all assets held by said Section 77-B Trustee for the account of others, or held by said Section 77-B Trustee in any agency or other segregated account pending settlement or determination of equities or rights asserted by others."

The "New Company" above referred to is the petitioner herein.

The second reorganization involved herein is that of Amalgamated Properties, Inc., a wholly owned subsidiary of the guarantor, used by it to take title to properties subject to defaulted mortgages in which certificates had been issued. In this way Amalgamated Properties, Inc., had obtained title to the property subject to the Burnside certificates.

On March 16, 1936, Amalgamated Properties, Inc., filed its petition for reorganization in the same District Court as a part of the reorganization of the guarantor, under the procedure then permitted by Section 77-B of the Bankruptcy Act (R. 181). Later this proceeding was severed from the reorganization proceeding of the guarantor, and the two reorganizations were thereafter conducted independently (Stipulation, par. 4, R. 321).

In the Amalgamated reorganization, the practice was to propose a separate Plan for each certificate issue (R. 181-

182). A separate Plan was thus proposed for the Burnside certificates and ultimately confirmed (R. 135-177). This Plan provided that the Burnside mortgage be assigned to Trustees and then extended and modified, and that the mortgaged property be transferred to the same Trustees without merger of the mortgage and fee. Such assignment and transfer were made, and Ferris, Long and Leifert, respondents herein, are now such Trustees, with all the rights of an owner of the mortgage (R. 142, 145). The certificates were modified to conform to the Plan, and the rights of the holders thereof were changed from those of tenants in common of the mortgage, to those of beneficiaries of a trust (Section 1, Part VI of the Plan, R. 148).

The guarantor filed a claim in the Amalgamated reorganization, based on its holding of the Burnside certificates reacquired by it. Objection was made that the guarantor, having defaulted, might not participate in the mortgage on a parity with the other holders of certificates whose claims it had guaranteed and not paid. The Burnside Plan provided that this question should be reserved for future determination, and that no interest should be paid on the Burnside certificates held by the guarantor,

> "• • • unless and until it shall have been finally adjudicated by a Court of competent jurisdiction whether or not The Prudence Company, Inc., or its Trustees, or their successors or assigns, are entitled to receive such cash or other property or securities and to share in the proceeds of the property to be assigned to the Trustee pursuant to the Plan and on a parity with other certificate holders or otherwise" (R. 175).

Pending such adjudication, the respondents-trustees are to hold in escrow the interest otherwise payable on the so-called "Prudence-owned Certificates." If the adjudication should be to the effect that such certificates are subordinate, then one-half of the interest otherwise payable thereon is to be paid into a sinking fund for the retirement of certificates, and the other half is to be distributed as additional interest on the publicly-held certificates (R. 175-176).

These provisions of the Plan constitute, as a matter of agreement, a complete disposition of the money allocable to the guarantor's certificates.

The Burnside Plan contained two other reservations. These were (1) an express reservation of all rights of action against the guarantor (R. 141), and (2) the following in Part IX, paragraph 5 (R. 154):

> "* * * the certificate-holders hereby expressly reserve any and all rights which they may have against said guarantor or guarantors by reason of any breach of any such guaranty or guaranties."

The Plan of Reorganization for the Burnside certificate issue was duly accepted in writing by the 77-B Trustees of the guarantor as prescribed by the Bankruptcy Act (Stipulation, par. 3, R. 320). Thus, the guarantor expressly became a party to the agreement and accepted its benefits in lieu of its distributive rights under the bankruptcy law. Petitioner is merely the successor of the guarantor, being, in effect, no more than a transferee of the assets at a bankruptcy sale.

The Burnside Plan as amended was duly confirmed on June 14, 1938, and is now in effect (R. 156-177).

Both reorganization proceedings have been terminated by appropriate final orders in each proceeding, and none of the present parties is or ever has been in bankruptcy (R. 189, 365).

Since respondents claim that the defaulting guarantor acquired the certificates (for which petitioner is now seeking parity), in connection with its guarantee and as a method of reducing that obligation *pro tanto*, the financial condition of the guarantor is important. During 1931, the year preceding the maturity of the certificates and of the mortgage, the cash position of the guarantor had deteriorated from approximately $3,500,000.00 as at June 30, 1931, to only $783,738.08 as at December 31, 1931. Its other assets, as at the latter date, consisted of marketable securities amounting to $168,045.25 and notes and accounts receivable amounting to $1,563,459.63. The balance of its assets were either pledged assets or the guarantor's own securities or those of affiliated companies (Stipulation, par. 1, R. 320).

Liabilities of the guarantor during 1932 on maturing mortgage securities guaranteed by it aggregated $22,791,433.00, or an increase of $21,816,333 over the comparatively small total of maturities of $875,100.00 for 1931. In view of the increasing defaults by mortgagors, the guarantor's assets were insufficient to pay the increasing maturities of mortgage securities guaranteed by it. The following table shows the pyramiding of maturities of obligations guaranteed by The Prudence Company, Inc., for the eleven years from 1927 to 1937:

1927	$ 100
1928	1,000
1929	2,600
1930	2,400
1931	875,100
1932	22,791,433
1933	32,488,177
1934	40,162,715
1935	26,230,120
1936	16,096,161
1937	10,676,186

Since the mortgages were no longer worth their face value, the guarantor was threatened with complete collapse. The directors took three moves in an attempt to avert this:

1. In November of 1931, they asked Reconstruction Finance Corporation for a loan of $25,000,000. (R. 320), which was granted in February of 1932, to the extent of $20,000,000. (R. 222-223). This loan was necessary for the guarantor "to keep on as a going concern" (R. 223). In its application for the loan, the guarantor stated that $12,000,000. thereof would be used "to renew maturing mortgages," since the mortgages, if foreclosed, would not bring in enough to pay off the loan:

> "• • • If we fail to renew selected maturing mortgages which we have guaranteed, the flood of foreclosure actions will necessarily result • • • in loss to investors in first mortgage securities, since their properties, when foreclosed, will bring only a fraction of the amount originally conservatively loaned thereon."

2. The guarantor invoked the eighteen months grace clause in its guaranty, and on January 1, 1932, notified the certificate holders that it had suspended principal payments (R. 211). At the same time the mortgagor defaulted in the payment of an instalment of principal due on the Burnside mortgage in January of 1932. Thus the mortgage was in default, although the default could not be enforced against the guarantor because of the grace clause. On June 13, 1932, the guarantor caused title to the mortgaged premises to be taken by its wholly owned subsidiary, Amalgamated Properties, Inc., which later executed an assignment of rents to the guarantor (R. 228-229).

3. The guarantor began acquiring Burnside certificates by purchasing them at a discount or by having the owners exchange them for certificates of other issues not in default and of later maturities. These acquisitions took place between March 3, 1932 and January 23, 1933 (Exhibit D, R. 59-63). The methods of acquisition will be discussed later, but prior to January 1, 1932 the guarantor had not owned any Burnside certificates (Stipulation, par. 6, R. 321).

SUMMARY OF ARGUMENT.

PAGE

I. No Bankruptcy Question or Other Federal Question is Involved 11

II. The New York Rule of Subordination is one of Substantive State Law Binding upon the Federal Courts 14

III. Irrespective of the New York Rule, the Guarantor's Claims, Having Been Acquired, as an Incident of its Guaranty, Must be Subordinated Under the Geist Case 17

IV. The Application of the Rule of Subordination Will not Create any Preference 22

V. The Petition for a Writ of Certiorari Should be Denied 24

ARGUMENT.

POINT I.

NO BANKRUPTCY QUESTION OR OTHER FEDERAL QUESTION IS INVOLVED.

The land subject to the mortgage is located in the State of New York. The bond and mortgage were executed in New York. The deposit agreement, the agreement of guaranty, and the certificates themselves were made, executed and delivered in New York. The guarantor acquired the certificates for which it now claims parity, in New York prior to the bankruptcy but after defaults. Its last purchase of Burnside certificates was on January 23, 1933; the bankruptcy did not occur until February 1, 1935. Thus, before the Bankruptcy Act could apply, or any other Federal jurisdiction attach, the relations existing among the certificate-holders of the Burnside issue and the guarantor had become fixed as a matter of state law. No law other than the law of the State of New York was applicable. If the certificates reacquired by the guarantor had become subordinate, *i.e.*, had become in effect junior in lien, that result had taken place long prior to the filing of the petition by the guarantor. The only right of the petitioner is as a transferee of those assets at a bankruptcy sale, with no greater rights than the bankrupt transferor, and that transfer, by the very order directing it, was subject to "all then existing equities and rights of third parties" (R. 119).

The reservations in the Burnside Plan (R. 175; 141; 154), extending expressly to "successors or assigns" of the guarantor (R. 175), and closely correlated with the reservations in the guarantor's Plan (R. 86; 95; 119), make it clear that nothing in either bankruptcy proceeding or in either Plan, purported to adjudicate or determine either the relative rights in the property held for the satisfaction of the mortgage, or the value or priority of lien of the certificates reacquired by the guarantor. Such relative rights and prior-

ities were, therefore, unaffected by the Reorganization Plans. Since the question of parity remained undecided at the time of the confirmation of the Plans, the "court of competent jurisdiction," referred to in the reservations, was required to determine the rights as of a time immediately preceding the filing of the petition, when those rights had become fixed as a matter of state law. This was the view adopted by the Court of Appeals of the State of New York, which, speaking through Thacher, J., said:

> "Upon this record it appears without contradiction that the Burnside Plan of Reorganization did not attempt to define or determine the relative rights of Realization Corporation as the holder of certificates acquired by Prudence and of other holders of Burnside certificates, nor was any determination of these rights made in the Bankruptcy Court in the course of its administration or in connection with the distribution of any of the assets either of Prudence or of Amalgamated. The controversy, therefore, was brought to the State courts, as contemplated by the Plan of Reorganization, for determination of these relative rights unaffected by the reorganization consummated in the Federal court" (R. 366; 292 N. Y. 210 at p. 218).

Thus, it clearly appears that no Federal question was involved, but that the State court was determining, as it was both permitted and required to do by the reservations, substantive questions of state law as of a time just prior to the filing of the petition.

The petitioner has attempted in its brief to assimilate the reservation in the order confirming the Zo-Gale Plan, considered in *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, with the reservations contained in the Burnside and Prudence Plans. Although it is stated in petitioner's brief, at page 12 thereof, that "the pertinent provisions of each Plan are substantially identical," this statement is not accurate, since the Zo-Gale Plan contained no reservations whatsoever. The only reservation was contained in the order confirming the Plan, when the Court, in closing the Zo-Gale proceeding, reserved jurisdiction to try the bankruptcy issue

then pending undecided before it. As even petitioner is forced to admit, at the top of page 15 of its brief, the question had therefore to be considered "as it existed at the time of the reservation"; that is to say, after the Plan had been confirmed without an agreement that the relative rights would remain unaffected by either the Bankruptcy Act or the reorganization Plan, whereas the reservations in the Burnside Plan require the determination of the question of parity as a matter of substantive right as of a time immediately preceding the filing of the petition.

Prior to the bankruptcy, the certificate holders bore a certain relation to the guarantor, and the guarantor's repurchased certificates had acquired a certain standing as to priority of lien. These relative rights and priorities could have been adjudicated prior to the bankruptcy as a matter of state law, or even during the course of the bankruptcy in the state courts by permission of the bankruptcy court. *Thompson* v. *Magnolia Petroleum Co.*, 309 U. S. 478-483. Hence the reservation in the guarantor's Plan significantly chose February 1, 1935, the date of the approval of its petition. The effect of the reservations was to carry the entire set of relations through the proceedings intact, so that they emerged from the bankruptcy after the final orders completely unchanged. Any other interpretation of the reservations either renders a large portion of both Plans nugatory, or, as the Court of Appeals said (R. 367), forces a modification of the Burnside Plan, and despite the agreements contained in the Plans, gives the petitioner, as successor of the defaulting guarantor, a higher position than the guarantor itself had. The reservation contained in the order closing the Zo-Gale proceeding was not a part of the Plan, did not define the treatment to be accorded to the certificates if subordinated, and had not been bargained for by the certificate-holders as a part of the consideration for their consents thereto. On the contrary, all the consents to the Zo-Gale Plan had been filed before the entry of the order containing the reservation (R. 182-184). Therefore, there could be no provisions such as those in the Burnside Plan for the treat-

ment of the certificates after the adjudication of the reserved question, in ways which differed, as a matter of agreement, from the bankruptcy rule of distribution.

The question in the *Geist* case was the strictly legal one of the guarantor's rights as a matter of bankruptcy distribution in the estate of the bankrupt, Amalgamated Properties, Inc. That question was reserved by the bankruptcy court itself in its own order, for determination by it, in, and as part of, the bankruptcy proceeding then pending before it. Distribution was ultimately to be made, not in accordance with any agreement, but "in accordance with the final adjudication of such court" (R. 184). Thus in deciding the question of bankruptcy distribution in the bankruptcy court, the bankruptcy rule necessarily applied. The question in the present case is, by force of the reservations, one of substantive rights created prior to the bankruptcy.

POINT II.

THE NEW YORK RULE OF SUBORDINATION IS ONE OF SUBSTANTIVE STATE LAW BINDING UPON THE FEDERAL COURTS.

One ground on which the *Geist* case, 316 U. S. 89, did not follow the New York cases was that the rule laid down therein was no more than "a local rule governing the liquidation of insolvent estates." However, the New York Court of Appeals in the case at bar has clearly adjudicated that the rule of subordination adopted by it is one of substantive law (R. 361). It held that the suits before it were neither proceedings in bankruptcy nor state liquidation proceedings, but were brought to determine relative rights in property held for the satisfaction of a mortgage (R. 361), and that such rights must be determined by the law of New York, where the land is situated and the bond and mortgage and other agreements were made and delivered (R. 362). After a careful review and analysis of the bankruptcy proceedings, the Court came to the clearly correct conclusion that the question of parity had been unaffected by the Plans or by any determination made in the bankruptcy court (R. 366).

and that, therefore, it was necessary for the Court of Appeals to determine under the law of the State of New York whether the petitioner was entitled to parity of treatment for its certificates (R. 367). This question it then decided as a matter of its own substantive law, in the actions before it, which were not liquidation or insolvency proceedings.

Prior to this decision of the Court of Appeals in *Ferris* v. *Prudence Realization Corporation*, there was doubt as to whether the rule of subordination in the title and mortgage company cases referred to therein, expressed a principle of substantive state law or merely a rule of distribution, as apparently found by this Court in *Prudence Realization Corporation* v. *Geist*, *supra*, at page 95. Notwithstanding such doubt, *Erie R. R. Co.* v. *Tompkins*, 304 U. S. 64, required this Court to find and apply the state law even if it were not clear, and even if the answe which the highest state courts would ultimately give might be uncertain.

Meredith v. *Winter Haven*, 320 U. S. 228, 237-238.

However, subsequent to the decision of this Court in the *Geist* case, the highest court of the State of New York has decided in the *Ferris* case that its principle of subordination is not merely a rule of distribution in insolvency proceedings, but is a principle of substantive state law applicable in all actions (R. 361, 362). Such decision requires a change in later rulings by Federal courts on the same point.

Madden v. *Metropolitan Life Insurance Co.*, 138 F. 2d 708 (C. C. A., 5th, 1943); cert. den. 64 S. Ct. 945;
Meredith v. *Winter Haven*, *supra*, at p. 238;
Erie R. R. Co. v. *Tompkins*, *supra*.

The question as to whether a principle of local law enunciated by a state court is a principle of substantive law or of adjective law, is itself one which must be settled by the state court. When the answer has been given by the highest state court, it is binding upon the Federal court, and the doctrine of *Erie R. R. Co.* v. *Tompkins* comes into play.

Palmer v. *Hoffman*, 318 U. S. 109, 117;
Francis v. *Humphrey*, 25 F. Supp. 1;
Sampson v. *Channell*, 110 F. 2d 754 (C. C. A., 1st, 1940, cert. den. 60 S. Ct., 1099);
Fort Dodge Hotel Co. v. *Bartelt*, 119 F. 2d 253, 258 (C. C. A., 8th, 1941).

Since the petitioner's certificates were subordinated as a matter of substantive state law prior to the bankruptcy, and since the reservations in the two plans require the present determination of the question unaffected by the bankruptcies, the New York Court of Appeals clearly reached the correct result and the petition for a writ of certiorari must be denied.

The second ground on which this Court in the *Geist* case did not follow the New York rule was that the conclusion of subordination was arrived at not from an examination of the relevant documents read in the light of surrounding circumstances, but simply from a "presumed intention" flowing from the application of the supposed rule of distribution. The opinion of the Court of Appeals in *Ferris* v. *Prudence Realization Corporation* does not rely on any "presumed intention," but on the contrary contains an exhaustive analysis of the relevant documents (R. 367-370). The Court considered the provisions of the deposit agreement (R. 368), the provisions of the certificate (R. 369), and the provisions of the guarantee (R. 370), and on the basis of these and other circumstances arrived at the conclusion that there was an actual agreement, and evidence of actual intent, to subordinate the guarantor (R. 373).

Thus, the deficiencies which this Court noted in the opinion of the Circuit Court of Appeals in *Geist* v. *Prudence Realization Corporation* (122 F. 2d 503) have been removed. There is on this record no room for the application of the arguments which prevailed in *Prudence Realization Corporation* v. *Geist*.

POINT III.

IRRESPECTIVE OF THE NEW YORK RULE, THE GUARANTOR'S CLAIMS, HAVING BEEN ACQUIRED AS AN INCIDENT OF ITS GUARANTY, MUST BE SUBORDINATED UNDER THE GEIST CASE.

After deciding not to apply the New York rule in the *Geist* case, this Court stated that "the question remains whether there is any equity arising from the Prudence Company's failure to perform its contract of guaranty, which a bankruptcy court should recognize as requiring subordination. * * *" 316 U. S., *supra*, pp. 95-96. It found that such equitable basis was wanting. However, the facts heretofore stated concerning the acquisition of the guarantor's certificates in this case prove conclusively that here such equitable basis does exist. In the *Geist* case, the guarantor sought parity for an unissued or "uncertificated" part of the mortgage amounting to $7,200., and for reacquired certificates amounting to $816.67.

This Court found that the guarantor had not acquired these interests as an "incident" to the guarantee and its rights were not "those of a subrogee". As to the $7,200 unissued part of the mortgage, this was necessarily true, since the rights were residual rights in the mortgage, acquired when the guarantor made the original mortgage loan, prior to its execution of the guaranty.

With respect to the $816.67 of repurchased certificates, this Court's finding was clearly required by the specific admission that the certificates were purchased as investments in the regular course of business. In the *Geist* proceeding, Prudence Realization Corporation, the guarantor's successor, alleged with respect to said repurchase as follows:

> "It was the intention in each instance upon the acquisition of the aforementioned certificates by Prudence to hold such certificates as investments, and the acquisition by Prudence was not intended at any time to constitute a cancellation or payment under its guaranty." (Record on appeal in *Prudence Realization Corporation* v. *Geist*, p. 24.)

This was specifically admitted by Geist, the Trustee, as follows:

> "William T. Cowin, president of Prudence Realization Corporation, the respondent herein, formerly a trustee of the debtor, states in his affidavit that in many instances The Prudence Company, Inc. reacquired certificates theretofore sold to and held by the public, and that it was the intention of The Prudence Company, Inc., to hold such certificates in its own investment portfolio as an investment.
>
> "This deponent does not take any exception to such statement but respectfully submits that this presents an incomplete picture." (Record on appeal, *supra*, fols. 118-120.)

In the Burnside Issue, the facts are entirely different. There was no "unissued" or "uncertificated" part of the mortgage. All the certificates were acquired by the guarantor *after default* as an incident to its guaranty, and in an obvious attempt to reduce or postpone its guaranty liabilities. The rights which petitioner now asserts are those of a subrogee, and hence there is a clear equitable basis for requiring subordination under the rules laid down in *Prudence Realization Corporation* v. *Geist*.

The precarious financial condition of the guarantor immediately preceding and during the time when it was re-acquiring its own defaulted securities has already been described. It may be briefly recapitulated, as follows:

1. November, 1931, the guarantor seeks a $25,000,000 loan from Reconstruction Finance Corporation, admitting in its application therefor that the mortgages, if foreclosed, would not bring enough to cover its guaranty liabilities—and, by necessary implication, that the guarantor without the loan would be unable to meet them.

2. December, 1931, the guarantor's balance sheets show it to be unable to meet its maturing guaranty liabilities for the year 1932.

3. Its guaranty liabilities for 1932 are over twenty-five times as great as for 1931, and for 1933, are about $10,000,000 more again.

4. January, 1932, the Burnside mortgage is in default in the payment of an instalment of principal.

5. January, 1932, the guarantor suspends principal payments on its certificates and invokes its eighteen months' grace clause.

6. February, 1932, the Reconstruction Finance Corporation loan is granted for $20,000,000, but the guarantor does not revoke its suspension of principal payments.

7. March 3, 1932, the guarantor acquires its first Burnside certificate.

8. June, 1932, the guarantor commences heavy acquisitions of Burnside certificates.

9. July 1, 1932, the Burnside mortgage and certificates mature and are not paid.

10. January 23, 1933, the last Burnside certificate is acquired.

Prior to March 3, 1932, the guarantor had not owned any Burnside certificates (Stipulation, par. 6, R. 321). In June, 1932, immediately preceding maturity on July 1, 1932, the guarantor acquired certificates aggregating $23,852.75 in principal amount. The balance of the certificates aggregating $405,860.11 in principal amount were acquired after maturity, and after default (R. 59-63).

The certificates were not cancelled at the time because, as the guarantor's assistant treasurer testified, they had matured, the mortgage had not been paid off, and cancellation was unnecessary (R. 216). Nevertheless, on March 1, 1933, certificates aggregating $425,212.86 were cancelled and one

certificate in that amount was issued to Reconstruction Finance Corporation. On April 4, 1933, this certificate was cancelled and another in the same amount was issued to The Prudence Company, Inc. (R. 63). The cancellations and reissues of the remaining certificates are shown at R. 63.

Three methods were used to acquire the certificates. The first was through a secret and concealed brokerage account called the "Pender-Bucklee-Merriam" account (R. 63), known only by a number (R. 224). This account was used to acquire certificates at prices described as "substantially less than the par value thereof" (R. 23) and "rather substantial discounts" (R. 216). The discounts ranged from 15% to 34% (R. 63), although the guarantor advertised to its security holders that it would attempt to repurchase directly from them at discounts of only one per cent (R. 210). The "Pender-Bucklee-Merriam" account was created "within the first three months of 1932" (R. 216), or shortly after the guarantor invoked the eighteen months' grace clause, and shortly before the Burnside mortgage and certificates matured.

To the extent that the guarantor purchased its matured and default securities at a discount, it was reducing *pro tanto* its guaranty liabilities. Hence, when it later asserts a claim based upon the certificates so acquired, it is in the position of a surety which has only partially fulfilled its obligations. Payment to it before the creditors are paid, will therefore not be permitted.

The second method of acquisition was to have the holders of matured or maturing Burnside certificates exchange them for certificates in other issues of later maturities (R. 212; Exhibit D, R. 5961). Sometimes the certificate holder would be given part cash and a new investment for the balance. All such new investments were later maturities than the Burnside certificates and were not yet in default. (Stipulation, par. 2, R. 320).

The purpose and effect of this practice was obviously to extend the time for the payment of the guaranty liabilities. Therefore, any claim based on certificates so acquired is de-

rived from, or incident to, the guaranty, and was not acquired independently of it.

The third method of acquisition was the direct purchase from the holder for the minimum amount of cash which he would take (R. 212, 226-227). When the certificate holder pressed for cash, his certificate "would be repurchased at five or six or seven, or sometimes even ten per cent. discount" (R. 227). Many certificates were purchased at "par flat" (R. 61-62), *i.e.* at a discount amounting to the accrued interest thereon (R. 227).

These acquisitions at a discount, were for the purpose of reducing the guaranty liabilities and petitioner, as successor to the defaulting guarantor, is now asserting rights which are derived from partial performance of the suretyship obligation.

Thus, the *Geist* case differs factually from the present case in that there is here a clear equitable basis for subordination in the circumstances surrounding the acquisition of the certificates by the guarantor. These undisputed circumstances show the acquisition of defaulted securities at substantial discounts just prior to and after maturity, when the guarantor, if not insolvent, had at the least, a seriously impaired capital, and was forced to borrow to keep in business. To say that such acquisitions were "independent of the guaranty" is to fly in the face of the facts. Under those circumstances, the guarantor could have had no thought but to reduce or postpone its pyramiding guaranty liabilities. It was struggling desperately to prevent or delay the debacle which finally occurred. It could not have purchased these certificates in the ordinary course of business, or for investment purposes, because at that time its business was not running any "ordinary course", and it had no funds available for investment in defaulted securities. It was simply engaging in salvage operations.

POINT IV.

THE APPLICATION OF THE RULE OF SUBORDINATION WILL NOT CREATE ANY PREFERENCE.

Petitioner argues that subordination will result in an improper preference to Burnside certificate holders. This argument is invalid under the circumstances of this case for the following reasons:

(1) Since subordination occurred as a matter of substantive state law more than two years before the bankruptcy, the recognition in bankruptcy of the relative rights and priorities so created does not constitute an improper preference under the Bankruptcy Act. The argument that subordination creates an improper preference is sound only on the assumption that the subordination was brought about through a state rule of distribution not affecting substantive rights and liabilities. This assumption has been destroyed by the decision of the Court of Appeals in *Ferris v. Prudence Realization Corporation*, 292 N. Y. 210.

(2) The reacquired certificates were assets of the bankrupt, to be liquidated by petitioner for whatever their value might be. If, by reason of subordination as a matter of substantive state law, their value was reduced, petitioner will realize less, but whatever the value, the asset, when liquidated, will be shared equally and ratably by all creditors of the guarantor, without preference or priority in favor of the certificate holders in the Burnside or any other issue.

(3) Petitioner has urged that a preference may result from subordination because in bankruptcy the guaranty claims must be allowed in full. In state rehabilitation proceedings, it argues, the guarantee claimants are treated as secured and required to reduce their claims, so that subordination of reacquired certificates is there equitable, but such equity disappears in bankruptcy. However, the plan under which the petitioner holds title to the

reacquired certificates, provides that the guaranty claims (although technically allowed in full) must be treated as secured and reduced by the value of the security. The basis of the argument is thus destroyed by the agreement reached in the Plan and although the lien position of the Burnside certificate holders is improved by subordination, their claims in the general assets of the guarantor suffer by the reduction, and this reduction operates to the general benefit, equally and ratably, of all creditors of the guarantor. Petitioner may not have the benefits of both the reduction in the claims *because* of the security, and also the full benefit of the security itself.

4. Even if subordination, and the results which flow from it as a matter of law, might be said to create a preference in bankruptcy *simpliciter* as distinguished from corporate reorganization in the Bankruptcy Court, such legal results have been prevented from occurring by reason of the agreement in the reorganization plan which provides otherwise. The Burnside plan provides that if there should be subordination, the money otherwise allocable to the subordinated certificates shall be divided between additional interest on non-subordinated certificates, and a sinking fund for the purchase of such certificates. Such provisions were not in the Zo-Gale plan considered in the *Geist* case, in which the results of subordination would follow strictly as a matter of law. The Burnside plan prevents these results. The operation of the sinking fund will reduce the senior lien and thus enhance the value of the subordinated certificates. Since the guarantor accepted these beneficial provisions, petitioner, as its successor, may not urge as a reason against subordination, a preference which can be created only in their absence.

POINT V.

THE PETITION FOR A WRIT OF CERTIORARI SHOULD BE DENIED.

It is urged that by reason of the foregoing the petitioner has failed to show any reason for the issuance of a writ of certiorari and that its petition should be denied.

Respectfully submitted,

JOHN ROSS DELAFIELD,
ROBERT McC. MARSH,
EUGENE BLANC, JR.,
Counsel for City Bank Farmers Trust Company and Martin S. Lindgrove, as Trustees, etc., Respondents.